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SUBJECT: IMF CONCLUDES STAFF MISSION: STILL MUCH WORK TO DO

REF: ANKARA 3206

1. (SBU) Summary: IMF Mission Director told us May 30 that, while the staff mission had gone somewhat better than he expected, Turkish authorities still had much work to do in the next 10-14 days if they hoped to see a Fund board review by end-June. The government needs to adopt new fiscal measures to address worrisome underlying budget trends. On the structural side, the GOT is behind schedule, and has promised to try to accelerate Parliamentary action on key legislation. Most important is rapid passage of legislation governing social security institutions. Turkish authorities have promised to tailor public procurement law amendments and the proposed rescheduling of social security arrears to Fund address concerns; Kakhonen is skeptical but is taking a wait-and-see approach. End Summary.

2. (SBU) IMF Mission Director Juha Kakhonen provided us with an outbrief this morning on the just-concluded staff mission. He said the mission had gone somewhat better than he expected, but added that his expectations had been low. The bottom line, he said, was that, if the GOT makes a strong effort in the next 1-2 weeks, it might be possible to schedule the Fifth Review before the end of June.

Need for More Fiscal Measures

3. (SBU) The Fund still does not have final fiscal data for the first four months, but believes Turkey probably met the primary surplus targets. However, this success disguises worrisome underlying trends. The Central Government underperformed, due to weaker-than-projected revenues, even counting the higher-than-expected revenues from the tax amnesty program. The explanation, per Fund staff, lies in part in the negative impact of the tax amnesty, which they believe has weakened overall compliance while generating an increase in certain tax refunds (which are paid out immediately, while payments of arrears are made over time). Other factors include below-target social security collections, which Kakhonen again blamed on expectations of an amnesty, and the government's failure to implement price increases on items such as electricity.

4. (SBU) The State Economic Enterprises (SEEs) overperformed, but this overperformance is not sustainable, per Fund staff. Kakhonen explained that SEEs had delayed expenditures in the first quarter because of the tight interim budget and problems caused by the procurement law. However, he expects the SEEs to "catch up" during the remainder of the year, and thus not to overperform in budget terms.

5. (SBU) To rectify the situation, the Fund is insisting that the government adopt new fiscal measures in the next 7-10 days. GOT bureaucrats already have identified measures that would fill most of the expected gap, but the politicians still have to approve them. According to Kakhonen, State Minister Babacan briefed the cabinet on the budget situation on May 28. The Ministers, who have been hearing nothing but positive reports (especially by Finance Minister Unakitan) about how the tax amnesty is providing excess revenue, were apparently shocked to learn the true situation. Kakhonen hopes that shock will spur them into agreeing to additional measures rapidly.

6. (SBU) Kakhonen commented on three other amnesties/reschedulings that have been in the news:

-- electricity arrears: The GOT already approved an amnesty that violates the LOI. GOT officials offered the weak excuse that the state-owned electricity distribution company (TEDAS) had decided, on its own, to implement the amnesty. To compensate for this move, the Fund has insisted that the draft LOI include a provision committing the GOT to cut off electricity supplies to any customer who develops new arrears;

-- farm debt to Ziraat Bank: Fund staff does not have a problem with the state bank's decision to reschedule certain agricultural loans because the bank had already determined that the loans in question were non-performing and had written them down to zero;

-- social security arrears: This is the big one. Under intense Fund pressure, GOT authorities have agreed not to proceed with a broad amnesty, but instead to insert a clause in new social security legislation that would allow rescheduling of certain arrears. Per Kakhonen, the Fund could accept some type of rescheduling provision, as long as it was drafted in consultation with Fund staff and authorized reschedulings only for those unable to pay (rather than indiscriminately). However, the first draft of the legislation the GOT presented to the Fund looked like a general amnesty, so Fund staff is awaiting a revised version.

More to Do on Structural Side

17. (SBU) On the structural side, there have been numerous delays. When the Mission arrived, the GOT had completed only one of the eight structural benchmarks for April-May (having to do with Central Bank internal auditing). Kakhonen's sense is that the authorities, having completed the Fourth Review and seeing market sentiment improve significantly, relaxed a bit. During the mission, the leadership woke up and realized they needed to move on a series of legislative measures. As a result, they have promised to try to accelerate Parliamentary approval of key legislation, including new laws governing the social security institutions and bankruptcy. Even so, Kakhonen expects most legislation will be delayed for at least one month (though Parliament may approve the new foreign investment law more quickly).

18. (SBU) The government is also behind on some end-June targets, including laying off redundant workers at SEEs and passing the Public Financial Management Reform law. Although the GOT technically does not have to meet these targets if the board review takes place before June 30, Fund staff will have to be able to say the reforms are on track. If the review is delayed, of course, these and other end-June targets come fully into play.

19. (SBU) Kakhonen addressed three other "problem areas":

-- public procurement law: although the government is still planning to amend this law, Kakhonen believes things are now moving in a better direction. Fund staff accept the need for some revisions, particularly regarding the treatment of some SEEs, such as utility companies. Also, the GOT procurement agency -- which had been complaining about being ignored -- now tells the Fund that it is fully involved in drafting the amendments. The Fund will continue to watch this closely to ensure the GOT does not weaken the law;

-- law on independent regulatory agencies: Fund staff is worried that this legislation might weaken the independent agencies. So far, per Kakhonen, GOT officials have been "telling us what we want to hear." Fund staff have not seen a draft, and are waiting for the GOT to fill in some gaps in the draft LOI on this issue;

-- Turk Telekom privatization: The "plan" the GOT approved in April was insufficient. In the past few days, the World Bank and GOT have clarified what is needed to move the process forward, though completion of an acceptable plan probably will not occur before the Fall.

General Comments

10. (SBU) Kakhonen said the key is for the GOT to adopt new fiscal measures and pass the law on social security institutions in the next two weeks, while getting any social security rescheduling "right." He noted that State Minister Babacan, while still having limited influence, has been playing a positive role. In addition to telling the cabinet the harsh truth about the fiscal situation, he urged the

Prime Minister and Finance Minister to stop pressuring the Central Bank to cut interest rates. (Note: When Kakhonen expressed concern on this point to Finance Minister Unakitan, the Minister picked up the phone and called CB Governor Serdengecti to apologize, per Kakhonen. End note)

11. (SBU) Kakhonen said that the budget financing situation looked better now than at the time of the Fourth Review, as Treasury has been able to roll over debt well and t-bill yields have fallen. Still, he expressed little optimism that Turkey would be able to do more than muddle through in the coming months.

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